Supreme Court, U.S.
FILED
JUN 26 2003
OFFICE OF THE CLERK

No. 02-1196

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 2002

THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION,

Appellant,

AGAINST

ETS PAYPHONES, INC.
AND
CHARLES E. EDWARDS,

Appellees.

On Appeal From the United States Court of Appeals for the Eleventh Circuit

BRIEF FOR PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION, INC. AS AMICUS CURIAE IN SUPPORT OF THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

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MOTION FOR LEAVE TO FILE BRIEF FOR PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION, INC. AS AMICUS CURIAE IN SUPPORT OF THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

The Public Investors Arbitration Bar Association, Inc. ("PIABA") is a national non-profit voluntary public bar association with a membership of some 550 attorneys. In order to be a member of PIABA, an attorney must devote a significant portion of his or her practice to representing public investors (non-industry members) in private arbitrations involving securities matters. PIABA hereby respectfully moves for leave to file the attached brief, as **Amicus Curiae**, in the present case. Permission of the appellant, the United States Solicitor General, has been obtained. Permission of Charles E. Edwards, appellee, was sought and denied.

The interest of PIABA in this case arises from the fact that a number of members are involved in private arbitrations where hundreds of investors purchased ETS investments or similar interests in payphones offered by other companies. The decision of this Court could strongly influence the outcome of these future arbitrations.

Beyond the issue of whether payphones schemes involve the sale of securities in the form of investment contracts, this Court's decision will impact a number of other similar investments presently being offered to the public. These investments include automated teller machines, credit card processing units, and Internet access terminals, among others. None of the interests in these schemes are registered as securities and many are fraudulent. If the decision of the Eleventh Circuit is allowed to stand, the payphone and the other major schemes will go largely unregulated. Further, the public investors will be denied the information and protection which the state and federal securities acts were designed to provide.

The focus of the brief of the Solicitor General on behalf of the Securities and Exchange Commission is limited to the Eleventh Circuit's analysis of the ETS payphone operation and its implications decision on the federal securities acts. The brief, which PIABA as **Amicus Curiae** seeks permission to file, will, however, have a wider focus. It will address the impact of this Court's decision on arbitration, state securities laws, and other types of similar schemes. It will provide the Court with an understanding of the potential impact that the Court's decision will have in these broader areas.

Respectfully submitted,

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In the
Supreme Court of the United States
October Term, 2002

The United States Securities and Exchange Commission,

Appellant,

against

ETS Payphones, Inc.
and
Charles E. Edwards,

Appellees,

On Appeal From the United States Court
of Appeals for the Eleventh Circuit
Brief for the Public Investor's Arbitration
Association, Inc., as Amicus Curiae

STATEMENT OF INTEREST OF THE PUBLIC INVESTOR'S ARBITRATION BAR ASSOCIATION, INC.

The Public Investors Arbitration Bar Association, Inc.("PIABA"), is a national non-profit voluntary public bar association with a membership of some 550 attorneys. In order to be a member of PIABA, an attorney must devote a significant portion of his or her practice to representing public investors (non-industry members) in private arbitrations involving securities matters.

The interest of PIABA in this case arises from the fact that a number of members are involved in private arbitrations where hundreds of investors purchased ETS investments or similar

interests in payphones offered by other companies. The decision of this Court will strongly influence the outcome of these actions.

Beyond the issue of whether payphones schemes involve the sale of securities in the form of investment contracts, this Court's decision will impact a number of other similar investments presently being offered to the public. There are similar investment plans presently being offered to the general public involving automated teller machines, credit card processing units, and Internet access terminals among others. None of the interests in these schemes are registered as securities and many are fraudulent. If the decision of the Eleventh Circuit is allowed to stand, the payphone and the other major schemes will go largely unregulated. Further, the public investors will be denied the information and protection which the state and federal securities acts were designed to provide.

SUMMARY OF ARGUMENT

PIABA believes the SEC has greatly understated the true issue in the present case. The real issue is whether any debt security or contract requiring the payment of a fixed return can be an investment contract. The Eleventh Circuit interpreted this Court's decision in **United Housing Foundation v. Forman**, 421 U.S. 837 (1975), defining the "profit" element of **Howey**[1] test for investment contracts, to exclude either the payment of interest or a contract fixed-return obligation. It reached this conclusion based upon its reading of **United Housing** requiring that the investor's profit must come from the earnings of the company. Interest or fixed return contract obligations may or may not come from the earnings of the enterprise because these obligations must be paid without regard to whether the enterprise earns a profit.

The correctness of this interpretation is a matter of national public interest. Both the SEC and the state securities

[1]SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

agencies spend a great deal of their enforcement resources dealing with novel or unusual securities. By far the most used portion of the statutory definition of a security in these cases is that of "investment contracts." Virtually all these novel securities cases also involve either Ponzie schemes or fraudulent conduct, often aimed at the unsophisticated and the elderly. The losses to the general public are enormous.

To understand the size of the problem, it should be noted that in addition to the SEC, at least 18 state securities agencies have taken action against ETS.[2] When enforcement activities against other payphone operations are included, the number of state enforcement actions soars to over 200.[3] The State of California alone has issued 143 Desist and Refrain Orders against 54 such entitles.[4]

This is, however, merely the tip of the iceberg. In the past, the agencies have had to deal with similar schemes involving automatic teller machines and other sale and lease-back promotions ranging from railroad cars to trailer trucks. *See e.g.*, **United States v. Jones**, 712 F.2d 1316 (9th Cir.), *cert. denied*, 464 U.S. 986 (1983)(trailer trucks).

These problems will also continue into the future. Ads are presently running on national television offering similar contracts on both Internet site locations and credit card confirmation

[2]See e.g., In re ETS Payphones, Inc., 2002 WL 1586379 (Ind. Div. Sec. June 7, 2002); In re ETS Payphones, Inc., 2001 WL 422179 (Ala. Sec. Com. Feb. 6, 2001); and In re National Communications Marketing, Inc., 2001 WL 236889 (Wash. Sec. Div. Feb. 26, 2001).

[3]Westlaw search, MSEC-CS, payphones /s securities. The search was done on March 11, 2003.

[4]Cal. Corp. Comm'n, Press Release 00-16 (2000), available at www.corp.ca.gov.

machines. Many are advertising that they are the successor to the payphone opportunities!

Beyond the sale and lease-back cases, the SEC and state agencies have had to deal with wide-spread Ponzi schemes involving promissory notes and international banking transaction frauds. *See e.g.*, **State v. Gerisch**, 49 P.3d 392 (Idaho 2002); **Mosley v. State**, 253 Ga. App. 710, 560 S.E.2d 305 (2002) The states have also been faced with the fraudulent sale of viatical settlement contracts.

If the Eleventh Circuit decision is upheld, the SEC will lose its most effective weapon to control and combat these schemes. Further, while the state courts are not obligated to follow federal decisions, they often do. Thus, a huge gap in both the federal and state agency enforcement programs will result. The white collar criminals will have carte blanche to conduct these various schemes with impunity.

The problem will also hamper criminal prosecutions and civil recovery. If the interests are not investment contracts or securities, criminal enforcement actions, such as **Szpunar v. State,** 783 N.E.2d 1213 (Ind. App. 2003), could not be brought. Nor would the state agencies be able to bring administrative actions and civil injunctive proceedings, such as **King v. Pope**, 91 S.W.3d 314 (Tenn. 2002).

This brief will attempt to accomplish two things. First, it will address why the Eleventh Circuit's position in the present case is wrong and should be overruled. Then, it will outline the two approaches the Court can take in overruling the Eleventh Circuit and establishing a meaningful and consistent public policy in this area.

There are numerous reasons why this Court should reverse the decision of the Eleventh Circuit. PIABA will demonstrate that the Eleventh Circuit's reading of **United Housing** was mechanical and unwarranted. It will also show that the **United**

Housing restrictions on "profits" are not supported by this Court's prior cases and the origins of the "investment contract" concept. Finally, PIABA will show that the **United Housing** restriction, as interpreted by the Eleventh Circuit, is inconsistent with the decisions of the other federal courts, the SEC, the state courts, and the state securities agencies.

Assuming that the Court is willing to overturn the Eleventh Circuit's decision, PIABA will then outline how the Court can accomplish this result. PIABA believes that the Court can accomplish this task in either of two ways.

The easiest and simplest approach would be to rule that interest or any fixed income can be considered a "profit" under the third element of the **Howey** test. While this approach will accomplish the appropriate result and is attractive because of its simplicity, PIABA would urge the Court to follow the second approach.

The Court should use this case as a vehicle for a broad rethinking of the elements of an investment contract and of a security in general. During the last fifty years, since the decision in **SEC v. W.J. Howey Co.**, the Court has dealt with the definition of an investment contract and that of a security in general on a piece-meal basis. Time is overdue for the Court to take the time to harmonize its various pronouncements as to what is a security and develop a single logical approach to this issue which is consistent with the intent of Congress in passing the Securities Act of 1933. In other words, in a logical and consistent manner, the Court needs to identify the elements of "securitiness" as well as of investment contracts.

In performing this task, the Court should determine the true nature of "securitiness" and a number of artificial tests which have grown up in the lower federal courts. The cases are largely the result of the Court's imprecision in its past pronouncement on the subject. The test should not be burdened with restrictions or

limitations which have no relevance to defining that which Congress sought to regulate in passing the Securities Act of 1933.

This Court, in many other areas, has sought to return to the original intent of Congress as determined by the language of the statute itself, its legislative history, and historical development as gleaned from similar statutes which Congress sought to use as a drafting model. The need is for a test to identify in a consistent and rational way, what are the elements of "securitiness."

In summary, PIABA urges the Court to reverse the decision in the present case and undertake the task of identifying the appropriate elements of "securitiness".

ARGUMENT

Technically, there is only one issue before the Court. This question is whether the Eleventh Circuit was correct in holding that an obligation to pay a fixed monthly amount for the use of payphones under a purchase and service contract prevents that agreement from being an investment contract. The Eleventh Circuit concluded that "the expectation of profits" element of the **Howey** test is not met by any interest-bearing agreement or contract requiring the payment of a fixed return. In doing so, the Eleventh Circuit interpreted **United Housing Foundation v. Forman**, 421 U.S. 837 (1975), which defined the "profit" element of **Howey** test to exclude either the payment of interest or a fixed-return. This conclusion was based upon its reading of **United Housing** to require that the investor's profit must come from the earnings of the company or enterprise. Interest bearing or fixed-return obligations may or may not come from such earnings because these debts must be paid without regard to the enterprise's profit.

POINT I

UNITED HOUSING DOES NOT JUSTIFY THE EXCLUSION OF PAYMENT OF INTEREST AND OTHER FIXED AMOUNTS FROM THE "PROFITS" ELEMENT OF THE HOWEY TEST

The language of **United Housing** does not require the exclusion of fixed-return or interest-bearing instruments from being investment contracts. Nor do the prior decisions of this Court. Further, such exclusion finds no support in either the policy behind the Securities Act of 1933 or the state law origins of the "investment contracts" concept.

A. THE LANGUAGE OF UNITED HOUSING DOES NOT DEMAND SUCH RESULT

The language of **United Housing Foundation, Inc. v. Forman**, 421 U.S. 837 (1975), does not require the interpretation given to it by the Eleventh Circuit. The thrust of **United Housing** was to distinguish those cases where the receiving of a true "profit" was the motivating force behind the investor's investment from those cases where the purchaser of the property was motivated by "the desire to use or consume the item purchased...." 423 U.S. at 852. In attempting to make this distinction, the Court made the following statement about the "profits" element of the **Howey** test, which the Eleventh Circuit relied to exclude interest-bearing and fixed-return contracts from coverage as investment contracts.

> **[The Howey] test, in shorthand form, embodies the essential attributes that run through all of the Court's decisions defining a security. The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or management efforts of**

> **others.** By profits, the Court has meant either capital appreciation resulting from the development of the initial investment as in **Joiner, supra**, ... or a **participation in the earnings resulting from the use of investor's funds**, as in **Tcherepnin v. Knight**.... **In such cases the investor is 'attracted solely by the prospect of a return' on his investment.** Id. [Emphasis added.]

The first example of "profits," capital appreciation, does not cause any problem. It is the second clause "a participation in the earnings resulting from the use of the investor's funds" which causes the problem. Read out of context, the phrase "earnings resulting from the use of investor's funds" could lend support to the Eleventh Circuit exclusion of debt and fixed payment instruments, if earnings are defined as gross or net profits of the enterprise. These obligations as debts must be paid regardless of profits or earnings. However, the Eleventh Circuit's interpretation is not the only possible interpretation. PIABA suggests that it is not the best interpretation for two reasons.[5]

First, the language must be put in context. When this is done, several things are clear. It is evident that the Court believes the **Howey** test, including its profits element, to be the litmus test for securities in general. If this is true, debt instruments can not be excluded because notes, bonds, debentures, and evidences of indebtedness are specifically included within the statutory definition. Thus, there would seem to be no intent to exclude interest or other fixed-payment instruments. Also, the questionable language is followed by the last sentence which reads: **"In such cases the investor is 'attracted solely by the prospect of a return' on his investment."** The emphasis here

[5]See a more detailed discussion of these reasons, in the Author's treatise, Blue Sky Law §2:58 (2002).

is on the expectation of a **return** to the investor. "Return" includes interest, dividends, and fixed-return payments.

Finally, it is clear that the language used was an example based upon the **prior** cases of the Court. As it happens, the Court, at that time, had never considered an investment contract case involving either a fixed return or a debt security.[6] Recognizing this fact, the Fifth Circuit in **Meason v. Bank of Miami**, 652 F.2d 542, 550, N.17 (5th Cir. 1981), commented that the quoted language "seems to us to be dubious value in [the note] context."

These three factors, taken together, mitigate against an intent to exclude some types of returns such as interest or fixed payments.

Second, if read the way the Eleventh Circuit did, the focus of the "profits" element would be reversed. The **Howey** test focuses on the **expectation** of a profit **to the investor**. **It does not focus on the enterprise in which the investment is made making a profit.** The investor doesn't care whether the enterprise makes a profit so long as his expectation of a return is fulfilled.

For example, in **Bell v. Health-Mor, Inc.**, 549 F.2d 342 (5th Cir. 1977), the investor was to receive ten dollars off the cost of his vacuum for every referral made. **The ten dollars was paid whether the referral bought a vacuum or not.** All that was required to receive the ten dollars was for the referral to allow a demonstration of the vacuum. The Fifth Circuit held the agreement to be an investment contract, despite the fact that the vacuum cleaner company might not make a profit because no sale is made.

[6]The Court has considered variable annuity contracts in SEC v. United Benefit Ins. Co., 387 U.S. 202 (1967) which have a fixed-return floor on the investment. The focus of the case, however, for investment contract purposes, was on the variable annuity feature.

The basis for the Eleventh Circuit's exclusion of fixed-return or interest-bearing debt securities on the other hand is that the enterprise must pay these obligations, so long as it is solvent, **without regard to whether it makes a profit**.

B. EARLIER SUPREME COURT CASES DO NOT SUPPORT THE EXCLUSION OF FIXED-RETURN OR INTEREST BEARING INSTRUMENTS FROM COVERAGE UNDER THE INVESTMENT CONTRACT ANALYSIS

This Court's first decision to deal with the concept of an investment contract was **SEC v. C.M. Joiner**, 320 U.S. 344 (1943). The Court in **Joiner** recognized that the definitions of a security found in both the Securities Act of 1933 and the Exchange Act of 1934 are not true definitions. Instead, they were definitions by enumeration. Some of the instruments named in the definition were "pretty much standardized and the meaning alone carries well settled meaning." 320 U.S. at 351. "Others are of a more variable character and were necessarily designated by more descriptive terms, such as ... 'investment contract'...." *Id.*

It also recognized that:

> [T]he reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as a matter of fact that they were widely offered or dealt in under terms or courses of dealing [that] established [them] as 'investment contracts.' Id.

Finally, the Court concluded:

> The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic

> inducements held out to the prospect. In the enforcement of an act such as this it is not inappropriate that promoters' offering be judged as being what they were represented to be.[7]

Id. at 352-353.

The Court found the oil and gas interests offered by Joiner were investment contracts. In doing so, it refrained from providing a test to identify "investment contracts." Nothing, however, in the Court's decision hints that fixed-return or debt securities should be excluded from classification as "investment contracts."

Three years later, in **SEC v. W.J. Howey Co.**, 328 U.S. 293 (1946), again considered what constituted an investment contract. The Court made two important observations in **Howey.**

First, it noted that the term "investment contracts" was not a defined term either in the statute itself or the legislative history. However, the term had been in use under the state securities or Blue Sky laws where "it had been broadly construed by state courts so as to afford the investing public, a full measure of protection."

Then, the Court went on to note that "investment contracts":

> [E]mbodies a flexible rather than static principle, one that is capable of adaptation to meet the

---

[7]This statement is particularly important in the present case because it emphasizes what the investors thought they were getting. In this case, the contracts were technically cast in the form of fixed payments for rent of the phone. From the perspective of many investors, they were making an investment which would receive a return on that investment, and would not participate in the management of the investment. They were buying an investment contract, not a contract for the payment of rent on a payphone.

> countless and variable schemes devised by those who seek the use of the money of others on the promise of profits. *Id.* at 299.

Finally, the Court announced the now famous test for an investment contract:

> [A]n investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. *Id.* at 298-299.

Based on this discussion, the Court concluded the scheme in **Howey** was an investment contract. Again, there is nothing in the language used or the Court's discussion which suggests that the profit can not be in the form of fixed payments or interest on debt securities. In fact, the SEC notes that two of the state cases relied upon by the Court in **Howey** involved fixed income or "guaranteed" returns. *See* **People v. White**, 12 P.2d 1078 (Cal. App. 1932) and **Stevens v. Liberty Packing Corp.**, 161 A. 193, 195 (N.J. Ch. 1932).[8]

The only support for the Eleventh Circuit's position is the *dicta* in **Reves v. Ernst & Young**, 494 U.S. 56 (1990). In **Reves**, the Court established when promissory notes would be securities. In footnote 4, the Court discussed the concept of "profits." It first said: "We emphasize that by 'profits' in the context of notes, we mean 'a valuable return on an investment,' which undoubtedly includes interest."

Then it added the following *dicta*:

---

[8]For a detailed discussion of these cases and the other state and lower federal court cases cited in **Howey**, see the Author's treatise, Joseph C. Long, Blue Sky Law §§1:17-1:18 (2002).

> We have, of course defined "profit" more restrictively in applying the **Howey** test to what are claimed to be investment contracts. [Citing **Forman**] To apply this restrictive definition to the determination whether an instrument is a "note" would be to suggest that notes paying a rate of interest not keyed to the earnings of the enterprise are not "notes" within the meaning of the Securities Acts. Because the **Howey** test is irrelevant to the issue before us..., we decline to extend its definition of "profits" beyond the realm in which that definition applies. 494 U.S. at 953, N.4.

The first part of this *dicta* appears to confirm the Eleventh Circuit's interpretation of **United Housing.** The Court, however, makes clear that its statement is *dicta* because the issue was not before the Court. Further, the last part of the *dicta* indicates that the Court might re-consider the definition of "profits" in respect to investment contracts in an appropriate case. The present case presents the Court with such an opportunity.

C. EXCLUSION OF FIXED PAYMENTS OR INTEREST FROM "PROFITS" UNDER THE HOWEY TEST FINDS NO SUPPORT IN THE STATE LAW ORIGINS OF THE CONCEPT OF "INVESTMENT CONTRACTS"

In **Howey**, the Court indicated that Congress had taken the definition of a security from previous state statutes. That definition, as were many sections of the originally proposed Securities Act of 1933, was drawn from the Uniform Sale of Securities Act adopted by the National Conference of Commissioners on Uniform State Laws. In turn, the Uniform Sale of Securities Act incorporated features of earlier state

securities. The words "investment contract" first appeared in the Arkansas Securities Act of 1913.[9]

Because of this incorporation of state law, the **Howey** Court indicated that it was appropriate to look to state law case for the definition of "investment contracts," since no definition was included in either the Securities Act of 1933 or the Uniform Sale of Securities Act. The Court said:

> By including an investment contract within the scope of §2(1) of the Securities Act, Congress was using a term the meaning of which had been crystalized by this prior judicial interpretation. It is therefore reasonable to attach that meaning to the term as used by Congress, especially since such a definition is consistent with the statutory aims.

Howey, 328 U.S. at 298.

The Court then proceeded to examine some eight state cases decided prior to the enactment of the Securities Act of 1933.[10] As noted above, SEC pointed out that two of these cases, **People v. White,** 12 P.2d 1078 (Cal. App. 1932) and **Stevens v. Liberty Packing Corp.**, 161 A. 193, 195 (N.J. Ch. 1932), involved a fixed income or "guaranteed" return. Clearly, these cases do not support the exclusion of fixed-return or interest-bearing instruments from coverage under investment contracts.

As the **Howey** Court noted, the first case to attempt to define "investment contract" was **State v. Gopher Tire &**

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[9]1913 Ark. Acts 214, at 904. See the Author's treatise, 12 Joseph C. Long, Blue Sky Law §1:16 (2002).

[10]For a discussion of those eight cases, see the Author's treatise, 12 Joseph C. Long, Blue Sky Law §1:17 (2002).

Rubber Co., 146 Minn. 52, 177 N.W. 937 (1920). The court in **Gopher** concluded that an investment contract was a contract involving "[t]he placing of capital or laying out of money in a way intended to secure **income** or profit from its employment...." [Emphasis added.] The use of the word "income" clearly would cover the receipt of interest or a fixed-return payment. Subsequent Minnesota cases affirm this conclusion.

State v. Evans, 154 Minn. 95, 191 N.W. 425 (1922), involved the sale of an interest in land under an installment plan. The contract provided that the investor could surrender his interest in the land and be paid a bonus of seventy dollars per each thousand invested over and above the return of his investment. The court found the arrangement to be an investment contract under the **Gopher** test. Five years later, **Webster v. U.S.I. Realty Co.**, 170 Minn. 360, 212 N.W. 806 (1927), a similar land sale contract with a cash out option which paid interest was found to be an investment contract. *See also* **Kerst v. Nelson**, 171 Minn. 191, 213 N.W. 904 (1927).

Examples of interest bearing or fixed-return contracts being held to be investment contracts was not confined to Minnesota. For example, both **Fidelity Inv. Ass'n v. Emmerson**, 318 Ill. 548, 149 N.E. 530 (1925) and **McCormick v. Shively**, 267 Ill. App. 99 (1932) involve such agreements.[11]

From these cases and other pre-1933 state cases, it becomes abundantly clear that the Eleventh Circuit's restriction on

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[11]In fact, the Illinois Act of that period defined investment contract. It indicated that a contract involving:

> a sum of money [to be paid] at a future date, either with or without interest, in consideration of a payment or payments made or contemplated to be made by such purchaser or holder, ... are hereinafter referred to as investment contracts.

Cahill's Revised Statutes 1931, Ch.12, ¶259(1).

"profits" does not find support in the early state cases. Investment contract, prior to 1933, involved the expectation of the receipt of **income** in the form of profits, interest, or the payment of a fixed return.

D. THE PUBLIC POLICY BEHIND THE SECURITIES ACT OF 1933 DOES NOT SUPPORT THE EXCLUSION OF FIXED PAYMENTS OR INTEREST FROM "PROFITS" UNDER THE HOWEY TEST

Probably the most important argument against adopting the Eleventh Circuit's exclusion of fixed-payments and interest from a "profit" comes from the purpose and public policy behind the Securities Act of 1933. The purpose of the Act was to ensure that the investing public had the necessary information to make an informed decision whether to purchase the security. The public policy behind the Act should be to define a definition of a "security" in such a way that all investors who need such information are covered by the Act, and those who do not are excluded. *Cf.* **SEC v. Ralston Purina Co.**, 346 U.S. 119 (1953).

The Court in **Howey** properly identified the category of investors who need the protection of the Act, when it said: "[A]ll the elements of a profit-seeking business venture are present here. **The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise."** *Id.* at 299. [Emphasis added.]

Put another way, a security is present when the capital providing function is separated from the management function. The investor supplies at least part of the capital. The promoter or a third party supplies the management and control of the operation. The investor needs to be supplied information about the company, its product, and the company's success in the marketing of the product. Further, the investor needs information about the people to whom he is entrusting his money.

Finally, the investor needs to be informed about his investment. Does it carry the right to vote in the entities affairs and to what extent? What return does the investment yield and does that yield vary, or is it fixed? Will this return be paid as long as the entity is solvent or is it dependent upon the profits of the enterprise? Where does the investment rank in bankruptcy and liquidation? What are the chances that investor will actually receive his return?

There are two types of investments where the investor does not need this information. As the above quoted language from **Howey** points out, the first example is where the investor actively engages in the operation or management of the enterprise. An example of this active participation is the general partnership where all partners exercise their statutory partnership rights to manage the partnership. Under this scenario, the investor, by participating in management, is in control of his own destiny. Further, the investor, by virtue of his participation, has access to the information necessary to make an informed investment decision.

The second type of investment is where the investment is totally passive. An example of this type of investment is where the investor, himself,[12] purchases a piece of raw land. He does not plan to develop the land or use it for agricultural purposes. The land is to remain idle. The investor hopes, however, that the land will appreciate in value. However, such appreciation is not related to anyone's concerted effort.

The above quoted language from **Howey** serve to eliminate the first situation where there is no need for investor protection. It indicates that there must be an investment with the expectation of a profit and the investor is passive. These are the

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[12]If he hires someone to exercise his special expertise in selecting the land, then an investment contract results because the selection process is the necessary active element.

first and third elements of the **Howey** test, investment with the expectation of a profit to come from the efforts of others.

The passive investment scenario is eliminated by the **Howey** common enterprise element. When properly construed, it requires nothing more than two people joining together to accomplish a common goal of making a profit for the investor. To accomplish this goal, someone other than the investor must actively generate the expected profits.

Thus, the **Howey** test is designed to meet the public policy of eliminating those persons who do not need the protection of the securities acts under "the investment contract" portion of the definition of a security. Or, as will be developed below, it identifies the elements of "securitiness" which should be applied to **all** parts of the definition.

In construing the various parts of the **Howey** definition, this public policy must be the pole star. No artificial element or requirement should be added which does not aid in identifying those people the Act was intended to cover.

A prime example of such an artificial test is the division over the meaning of "common enterprise." The Sixth and Seventh Circuits, based upon the facts of **Howey**, claim that there must be multiple investors. The Ninth Circuit requires the promoter or third party to share in the profits of the enterprise.

Neither of these requirements furthers the goal of identifying persons to be protected. A single investor buying what otherwise would be an investment contract needs the same protection as when two or more investors buy the same investment. Likewise, the investor who receives all the profits generated by the promoter or third party needs the protection of the Act, if he is passive, as does a similar investor who only receives part of the profits.

PIABA submits that the Eleventh Circuit's elimination of interest and fixed-returns from the definition of profit is merely another artificial restriction. The Court in **Reves** in the footnote quoted above recognized that for the purposes of promissory notes "profits" should include interest. The same is obviously true for bonds, debentures, and other evidences of indebtedness contained in the statutory definition.

The question then becomes whether there is something inherent in the nature of an "investment contract" that requires different treatment. PIABA submits that the answer to this question is "no."

PIABA believes the **Howey** test outlines the elements of "securitiness." PIABA also believes that these elements are found in all the enumerated terms in the definition of a security. Therefore, "profit" should not be treated differently under the "investment contract" portion of the definition than it is when dealing with other portions of the definitions such as notes, bonds, debentures, or other evidences of indebtedness. A "profit" for the purpose of identifying those persons needing the protection of the securities is a "profit" whether it takes the form of a dividend, interest, or payment under a fixed-return obligation.

The Eleventh Circuit, by excluding interests and payment under fixed-return obligations, has simply created another irrelevant artificial test which does not help accomplish the purpose and public policy behind the Securities Act of 1933. This Court should strongly reject such effort.

E. EXCLUSION OF FIXED PAYMENTS OR INTEREST FROM "PROFITS" UNDER THE HOWEY TEST IS CONTRARY TO THE HOLDINGS IN MANY OTHER LOWER FEDERAL COURT DECISIONS

Two federal district courts, in addition to the trial court in the present case, **SEC v. ETS Payphones, Inc.,** 123 F. Supp.2d

1349 (N.D.Ga. 2000), rev'd ___F.3d___ (11th Cir. 2002), have held that payphone schemes similar to that in the present case are investment contracts. **SEC v. Phoenix Telecom, LLC**, 2000 U.S. Dist. LEXIS 22314 (N.D. Ga. Aug. 2, 2000) and **SEC v. Alpha Telecom, Inc.,** 187 F. Supp.2d 1250 (D. Ore. 2002).

Since the **United Housing** decision, both the Third and the Ninth Circuits have rejected the exclusion of interest or fixed payments from the **Howey** definition of profit. In doing so, they have held that fixed-return or debt securities can be investment contracts.

The Third Circuit in **SEC v. Infinity Group Co.**, 212 F.3d 180, 189 (3d Cir. 2000), stated "the definition of security does not turn on whether the investor receives a variable or fixed rate of return." Similarly, in **United States v. Carman**, 577 F.2d 556, 563 (9th Cir. 1978), the court rejected the defendant's argument that the student loans involved in that case were not investment contracts. The contracts provided that the return on these student loans carry a fixed interest return. Further, the interest was guaranteed by the federal government. The Ninth Circuit held these contracts to be investment contracts. *See also* **United States v. Farris**, 614 F.2d 634, 641 (9th Cir.1979)(promissory notes on real estate) and **United States v. Jones**, 712 F.2d 1316 (9th Cir.), *cert. denied*, 464 U.S. 986 (1983)(sale and lease back of semi-trailer).

Finally, the Eleventh Circuit decision in the present case is in conflict with other binding decisions by the Fifth Circuit prior to the creation of the Eleventh Circuit. In **Bonner v. City of Prichard**, 661 F.2d 1206 (11th Cir. 1981)(en banc), the Eleventh Circuit adopted as precedent all decisions of the former Fifth Circuit decided prior to October 1, 1981.

Immediately before the creation of the Eleventh Circuit, the Fifth Circuit in **Meason v. Bank of Miami**, 652 F.2d 542, 550, N.17 (5th Cir. 1981) recognizing that this Court had never

had a note case before it, rejected the district court's holding that an investment was not a security, merely because the investor received a fixed-return on the investment.[13] It stated the definition of "profits" in the **United Housing** case "seems to us to be dubious value in [the note] context." Similarly, in **Bell v. Health-Mor, Inc.**, 549 F.2d 342 (5th Cir. 1977), the Fifth Circuit found an investment contract where the purchaser of a vacuum cleaner was to receive ten dollars for every referral made. The ten dollars was payable, if the referral allowed a demonstration of the vacuum **whether or not a sale was made.**

F. EXCLUSION OF FIXED PAYMENTS OR INTEREST FROM "PROFITS" UNDER THE HOWEY TEST IS CONTRARY TO THE POSITION TAKEN BY THE SEC

As the SEC notes in its Brief Seeking Certiorari, 23-24, and its brief on the merits, both the exclusion of interest and fixed payments from the definition of "profit" runs contrary to the long standing position of the SEC in its administrative actions. *See e.g.*, **In re Abbett, Sommer & Co.**, 44 S.E.C. 104, 1969 WL 95369 (1969) and **In re Union Home Loans,** 26 S.E.C. Dkt 1517, 1982 WL 522493 (Dec. 16, 1982).

Further, the Commission has argued in its enforcement cases involving "Prime Bank" and various other schemes that such schemes are investment contracts. This position is taken in spite of the fact that most of the schemes provide the investor with a guaranteed rate of return. *See also* **SEC v. Herula**, C.A. No. 02-154-ML (D. R.I. June 20, 2003)(Prime Bank); **SEC v. Yoder**, No. #:03-CV-0418AF (N.D. Ind., filed June 19, 2003);

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[13]Meason indicates other courts have not accepted the idea that a fixed return disqualifies the finding of an investment contract., citing Khadem v. Equity Sec. Corp., 494 F.2d 1224, 1229 (9th Cir.), cert. denied, 419 U.S. 900 (1974); SEC v. Nat'l Executive Planners, Ltd., 503 F.Supp. 1066 (M.D.N.C. 1980); and SEC v. Weeks Sec. Inc., 483 F.Supp. 1239, 1243-1244 (S.D. Tenn. 1980).

SEC v. Capital Holdings, L.L.C., CA No. 03-RB-0923 (D. Colo., filed May 21, 2003).

This argument appears to have been accepted by the courts. For example, **SEC v. SG, Ltd.**, 265 F.3d 42, 54 (1st Cir. 2001) involved virtual reality shares. Relying heavily upon **Joiner,** the First Circuit found the shares to be investment contracts. In discussing the "profits" element of **Howey**, the court noted: "SG flatly guaranteed that investments in the shares of the privileged company would be profitable, yielding monthly returns of 10% and annual returns of 25%. In our view, these profit-related guarantees constitutes not-very-subtle form of economic inducement...."

G. EXCLUSION OF FIXED PAYMENTS OR INTEREST FROM "PROFITS" UNDER THE HOWEY TEST IS CONTRARY TO THE POSITION TAKEN BY MANY STATE COURTS

Many state courts have rejected the idea that fixed fee agreements and debt securities can not be investment contracts. These courts have construed the definition of "investment contracts" under the state securities acts to cover both fixed payment agreements and promissory notes. *See e.g.*, **State v. Gerisch**, 49 P.3d 392 (Idaho 2002); **Mosley v. State**, 253 Ga. App. 710, 560 S.E.2d 305 (2002); **Bayhi v. State**, 629 So.2d 782 (Ala. Crim. App. 1993); **State v. Philips**, 108 Wash.2d 627, 741 P.2d 24 (1987), all promissory note cases. *See also* **Manns v. Skolnik**, 666 N.E.2d 1236 (Ind. App. 1996)(a contractual obligation to pay fixed return case). The most recent of this series, **Rasch v. State**, 579 S.E.2d 817 (Ga. App. 2003), was decided while the petition for certiorari was pending before this Court. More specifically, two state cases, **King v. Pope**, 91 S.W.3d 314 (Tenn. 2002)(a payphone case with fixed monthly payments similar to ETS), and **Szpunar v. State**, 783 N.E.2d 1213 (Ind.

App. 2003)(another payphone scheme), have held that payphone sales involve the sale of an investment contract.

Several of these state decisions speak directly to the question of whether fixed fees or interest can qualify as "profits." In **Payable Accounting Corp. v. McKinley**, 667 P.2d 15, 19 (Utah 1983), the court said "the critical factor is not whether the rate of return is fixed, but whether the 'investment transaction is so structured that the money to pay off the investor eventually will be generated by the venture or enterprise.'"

In **People v. Figueroa**, 41 Cal. 3d 714, 715 P.2d 680, 224 Cal. Rptr. 7119 (1986)(en banc) also addressed the issue of fixed payments, saying:

> Many "investment contracts"...contemplate both a variable and a fixed return. The investment contracts in [**People v. Coster**, 151 Cal. App.3d 1188, 199 Cal. Rptr. 253 (App. 1983)], for example purported to give the investor a 20 percent "fixed" return on principal and 1 percent of the **gross** company income. [Citation omitted.] Both kinds of return, as well as a recoupment of principal depended on the success of the business.... It would be illogical to [to exclude] a promissory note transaction simply because the promised return ... is to take the form of interest at a "fixed" rate. Id. at 740, 715 P.2d at 698, 224 Cal. Rptr. at 737. [Emphasis added.]

H. EXCLUSION OF FIXED PAYMENTS OR INTEREST FROM "PROFITS" UNDER THE HOWEY TEST IS CONTRARY TO THE POSITION TAKEN BY STATE SECURITIES AGENCIES

Likewise, the state securities agencies themselves have rejected the idea that an instrument calling for either the payment

of interest or a fixed fee can not be investment contracts. As noted in Point I, at least 18 state securities agencies have brought administrative enforcement actions against ETS. New York has also brought an action against another company offering a similar fixed return plan. **State of New York v. Justin**, 237 F. Supp.2d 368 (W.D.N.Y. 2002). At least two of these state ETS cases were contested cases, and both were decided after the Eleventh Circuit's opinion in the present case. **Both** rejected the Eleventh Circuit's position. In **Stigall v. Sec. of State,** Case No:EN-18727 Final Decision (Sept. 6, 2002), slip op. at 13. the Georgia Commissioner said:

> The Commissioner rejects the Eleventh Circuit's analysis of the third element of **Howey** as being inextricably intertwined with its narrow view of "profits." ... [T]he fact that there is a contractual guarantee of payment which might be satisfied from the capital of the enterprise is as irrelevant in this case as it would be in a case involving a promissory note. "The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae."

Likewise, in **Department of Banking and Finance v. Mehl**, DOAH Case No. 02-0526, 2002 WL 31452438 (Fla. Sec. Div., Final Order, Oct. 17, 2002), the Florida Comptroller rejected the Eleventh Circuit approach under the Act. The Comptroller said "Florida law does not use such a narrow construction of 'profits,' it has not distinguished between fixed or variable returns to the investor." As outlined in Point I, sixteen other state securities agencies have also taken action against ETS under the investment contract analysis. A number of new orders

have been entered during this Court's deliberation whether to grant certiorari.[14]

In summary, there is no basis in the language of the Securities Act, the prior case law from this Court, the history of the concept of "investment contract," or the public policy and purpose behind the Act to support the Eleventh Circuit's exclusion of interest and payment under a fixed-return contract from the definition of "profits" under the **Howey** test. Further, such limitation runs contrary to the holdings of other federal courts, the SEC, the state courts, and the state securities agencies which have held that interest may constitute a profit for investment contracts purposes.

POINT II

IN REVERSING THE ELEVENTH CIRCUIT, THE COURT SHOULD CONDUCT AN OVERALL REVIEW OF "SECURITINESS"

Assuming that the Court is willing to overturn the Eleventh Circuit's decision, PIABA suggests that the Court can accomplish the result of assuring that interest and payments under fixed-return contracts are included in the definition of "profits" in either of two ways. The easiest and simplest approach would be to rule that interest or any fixed income can be considered a "profit" under the "profit" element of the **Howey** test. The second way is for the Court to use this case as a vehicle for a broad rethinking of the elements of an "investment contract" and of a "security" in general. PIABA urges the Court to follow the second choice.

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[14] See e.g., In re Mack, 2003 WL 21269563 (Ohio Dept.Comm., May 30, 2003); In re Ray, 2003 WL 21269561 (Ohio Dept.Comm., May 22, 2003); and In re Ellsworth, 2003 WL 21207816 (Mo.Div. Sec., April 29, 2003).

A. THE COURT SHOULD NOT SIMPLY REDEFINE "PROFITS" TO INCLUDE INTEREST AND FIXED PAYMENTS

As noted above, the simplest way to resolve the present case is to reverse the Eleventh Circuit. It can, at the same time, disaffirm the *dicta* in both **United Housing** and **Reves.** Then, the Court can make crystal clear that "profits" under **Howey** includes both interest bearing agreements and fixed-return contracts. In so doing, the Court would bring the definition of "profits" under the investment contract portion of the definition in line with the definition "profits" used in the **Reves** case for promissory notes.

While this approach will accomplish the appropriate result and is attractive because of its simplicity, PIABA would urge the Court not to limit its pronouncement in this way. This approach is merely applying another band-aid to an area where prior case law by this Court, as well as the other federal courts, is in serious confusion. This confusion has resulted in losing sight of the purpose of, and policy goals behind the Securities Acts.

B. THE COURT SHOULD UNDERTAKE A RECONSIDERATION OF THE WHOLE CONCEPT OF WHAT IS A SECURITY AND IDENTIFY THE ELEMENTS OF "SECURITINESS"

PIABA urges the Court to use the present case as a vehicle for a broad re-thinking of the elements of an investment contract and of a security in general. It has been almost sixty years since the landmark decision in **SEC v. W.J. Howey Co.** During this period, the Court has dealt with the definition of a security as well as the definition of an investment contract on a piece-meal basis. This approach has resulted in a great of uncertainty in an area where predictability is extremely important.

PIABA believes that time is overdue for the Court to take the time to re-think the entire concept of what is a security. In

doing so, the Court can harmonize its various pronouncements and develop a single logical approach to this issue. The result should be a definition of investment contracts, and "securitiness" in general, which is consistent with the intent of Congress in passing the Securities Act of 1933.

In performing this task, the Court should strive to eliminate a number of artificial tests which have grown up under various elements of the **Howey** test. These artificial or mechanical tests do not help identify the people which Congress intended to have the protection of the Securities Act. These tests have developed largely because of the imprecision of the Court in its past pronouncements. These tests merely burden the definition of investment contracts, and securities in general, with restrictions or limitations which has no relevance to defining that which Congress sought to regulate by passing the Securities Act of 1933.

This Court, in many other areas, has sought to return to the original intent of Congress as determined by the language of the statute itself, its legislative history, and historical development as gleaned from similar statutes which Congress sought to use as a drafting model. The Court needs to undertake such a re-analysis in the securities area and develop, in a consistent and rational way, what are the elements of "securitiness."

PIABA believes the Court in **Howey** long ago identified the four proper elements of a security. As discussed above in Point ID, these are an investment in active enterprises motivated by the expectation of a profit or return to the investor where some one other than the investor will perform the managerial and entrepreneurial functions necessary to generate that profit or return.

The investment should not be limited to money, but should include services performed or the use of property given to the enterprise.

The enterprise must be actively doing something to generate the expected profit. Further, it should make no difference whether there is only one investor or many. Likewise, it is irrelevant whether the promoter or third person participates in the profits or return.

The profits or return should include interest, dividends, and fixed payments. Further, it should not be limited to the payment of money, but should include the distribution of other securities or property.

Finally, to be excluded under the efforts of others test, the right to participate in management must come from the ownership of the securities and not the holding of an office such as an officer or director of a corporation. Also, the right to participate in management must be a right to directly participate in the management of the enterprise, and not be indirect management as in the case of election of the directors of a corporation.

To confirm these elements of "securitiness", the Court should apply the above elements to stock in a corporation. The Court in **Landreth Timber Co. v. Landreth**, 471 U.S. 681, 105 S.Ct. 2297 (1985), held that stock was the quid essential example of a security.

To obtain stock in a corporation, the shareholder must invest money, property, or services in the corporation. The corporation is actively doing something, such as manufacturing goods or performing services, to generate a profit. The investor has made his investment in the corporation in the expectation that he will receive a profit in the form of dividends or an appreciation in the value of his stock.

Finally, his stock ownership may or may not give him the right to participate in the election of the board of directors and on certain extraordinary events such as merger or sale of assets. Yet this right is a derivative right. It does not allow the shareholder to direct the day-to-day operations, merely elect the directors who

are responsible for such operations. Stock then has all the essential elements of "securitiness" identified by **Howey.**

A similar result will be reached, if the elements are applied to bonds and debentures. The active enterprise element will eliminate from coverage under the Act of those notes and evidences of indebtedness used to fund the purchase of car, boat, or home where the purchaser is consuming the goods for his own personal use rather than employing them in an active enterprise to generate a profit.

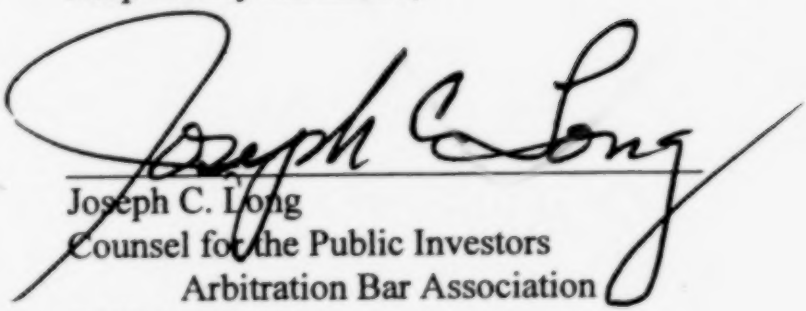
After over ninety years of securities regulation, it is time to positively identify the elements of the interests to be regulated rather than relying upon a laundry list of items which might or might not carry the elements of a security. PIABA urges the Court to use the present case to undertake such an identification task.

SUMMARY

Based upon the above outlined cases and agreements, PIABA urges the Court to reverse the Eleventh Circuit and find the ETS interest to be investment contracts. In doing so, PIABA urges the Court to reject the idea that a "profit" under the **Howey** test can not be interest or the payment of a fixed return. Finally, PIABA urges the Court to undertake a re-thinking of the area of what is a security. In doing so, the Court should isolate the elements of "securitiness" common to all securities. PIABA believes that these elements are found in the **Howey** test as interpreted above.

Dated: June 26, 2003
Norman, OK 73072

Respectfully submitted,



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